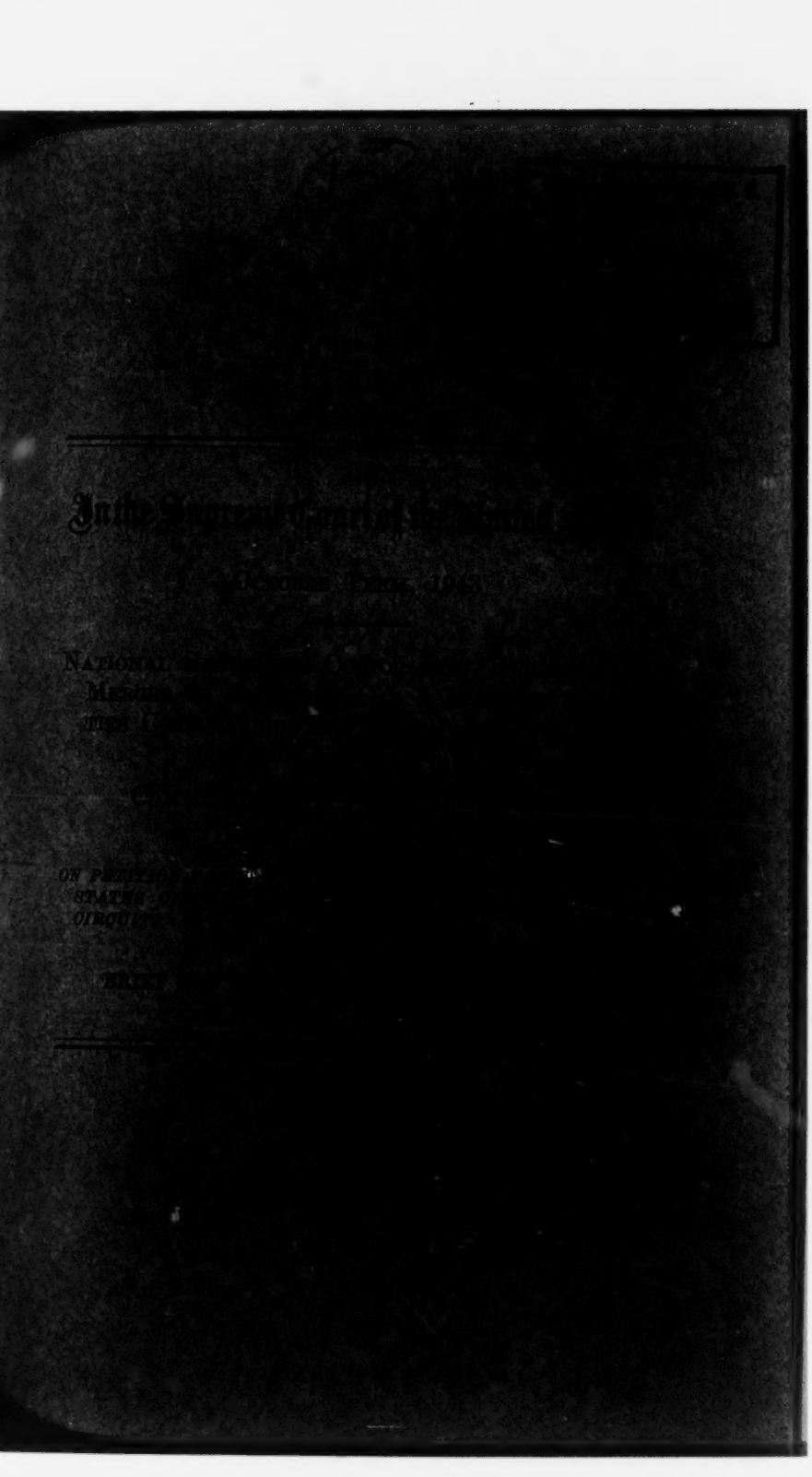

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In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 458

NATIONAL SECURITIES CORPORATION, SUCCESSOR BY MERGER TO AMERICAN GAS & ELECTRIC SECURITIES CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 13a–22a) is reported in 46 B. T. A. 562. The opinion of the Circuit Court of Appeals (R. 66–72) is reported in 137 F. 2d 600.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on July 28, 1943 (R. 72–73.) The petition for a writ of certiorari was filed October

26, 1943. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Has the Commissioner of Internal Revenue exceeded his authority under Section 45 of the Revenue Act of 1936 in allocating to a parent corporation a portion of a loss claimed by its subsidiary on the sale of stock?

STATUTE INVOLVED

The provisions of the statute involved are set out in the Appendix, *infra*, pp. 10–12.

STATEMENT

The facts as found by the Board of Tax Appeals (R. 14a–16a) may be summarized as follows:

The taxpayer's predecessor, American Gas & Electric Securities Corporation, hereafter referred to as American Gas or subsidiary, was incorporated under the laws of the State of Maryland on June 23, 1925. The National Securities Corporation, the taxpayer, is a Maryland corporation, incorporated on September 24, 1929, with its principal office in New Jersey. In 1939 American Gas was merged with the taxpayer, which succeeded to all the property, rights, privileges, and franchises of American Gas and became liable for all obligations of American Gas. After

the merger the separate existence of American Gas ceased. (R. 14a.)

American Gas was a wholly owned subsidiary of the American Equitable Assurance Company of New York, a fire insurance corporation, hereafter referred to as the parent. On January 1, 1936, American Gas had issued and outstanding capital stock consisting of 3,000 shares without par value for which the parent had paid $300,000 in cash. The fair market value of the net assets of American Gas at December 31, 1935, amounted to approximately $276,270. The sole business of American Gas was investing in, purchasing and selling securities. (R. 14a–15a.)

At the close of the calendar year 1935 the parent owned 3,500 shares of the common stock of Standard Gas & Electric Company, hereafter referred to as Standard, which it had previously purchased at a total cost of $418,780.19. During the year 1935 reorganization of Standard was commenced under Section 77B of the Bankruptcy Act. At the close of 1935 the Standard stock held by the parent had a fair market value of approximately $6.25 per share. (R. 15a.)

During January 1936 the parent sold 2,500 shares of Standard stock in the open market at prices ranging from $7.75 to $9.125 per share. On February 13, 1936, it transferred to American Gas its remaining 1,000 shares of Standard common stock in exchange for 800 shares of the authorized capital stock of American Gas at no

par value. These shares of Standard stock had cost the parent $140,378.06 and had a fair market value on February 13, 1936, of $8,562.50. The American Gas shares given in exchange had a declared value of $10 per share and an indicated fair market value of over $92 per share. (R. 15a.)

On December 11, 1936, American Gas sold the 1,000 shares of Standard common stock, acquired from the parent on February 13, 1936, on the open market, for a net price of $7,175. The selling price was not paid to the parent, but to American Gas. (R. 15a.)

American Gas, in its tax return for 1936, deducted $133,203.06 as a loss on the sale of the Standard stock representing the excess of the cost of the stock to the parent over the amount received by American Gas on the sale[1] (R. 15a-16a).

The Commissioner disallowed the deduction of $133,203.06 claimed by American Gas, and under the provisions of Section 45 of the Revenue Act of 1936 allocated the loss to the parent (R. 16a). He determined a deficiency in tax of $39,367.90 for the year 1936 (R. 7a).

At the hearing before the Board, the Commissioner conceded that the taxpayer was entitled to

[1] The parent's 1936 return discloses an excess of capital losses on the sale of securities over capital gains of approximately $15,600, of which only $2,000 was allowed under the provisions of Section 117 of the Revenue Act of 1936. The parent treated the transaction of February 13, 1936, as falling within Section 112 (b) (5) and accordingly did not claim a loss deduction in its 1936 return. (R. 16a.)

the deduction of a loss equal to the difference between the fair market value of the shares at the time acquired, $8,562.50, and the amount of $7,175, for which they were sold, the difference being $1,387.50 (R. 15a–22a).

The Board held that the extent of the taxpayer's deductible loss was $1,387.50 and that the allocation by the Commissioner of the balance of the loss to the parent under Section 45 of the Revenue Act of 1936 was not arbitrary or capricious but proper under the circumstances of the case. The Board determined a deficiency in tax of $38,916.39 (R. 22a). The Circuit Court of Appeals affirmed (R. 72).

ARGUMENT

There is no conflict and the basic principles underlying the decisions below have been established by many decided cases.

The case involves the power of the Commissioner to apportion or allocate gross income or deductions, under Section 45 of the Revenue Act of 1936 (Appendix, *infra,* p. 11), among controlled corporations and does not involve, as asserted in the petition, the denial of a loss or its computation on a different basis from that prescribed by law.

In enacting Section 45 Congress has conferred broad powers of administrative discretion upon the Commissioner, the exercise of which is not subject to court review in the absence of clear

abuse.[2] That section authorizes the Commissioner to distribute, apportion or allocate "gross income or deductions among two or more organizations, trades, or businesses" "owned or controlled directly or indirectly by the same interests * * * if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations." The purpose of Congress in enacting Section 45 (first appearing in its present form in the Revenue Act of 1928, c. 852, 45 Stat. 791) was to prevent the avoidance of taxes[3] or the distortion of income by the shifting of income or deductions among affiliated companies.

Under the provisions corresponding to Section 45 in prior Revenue Acts,[4] giving the Commissioner power to consolidate the accounts of related trades and businesses for the purpose of making

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[2] *G. U. R. Co.* v. *Commissioner*, 117 F. 2d 187, 189 (C. C. A. 7th); *First Securities Corp. of Memphis* v. *Clements*, 103 F. 2d 1011 (C. C. A. 6th). Cf. *Heiner* v. *Diamond Alkali Co.*, 288 U. S. 502, 507.

[3] Consistent with the evident purpose of the statute, the expression "evasion" of taxes has been held to mean "avoidance" of taxes. *Asiatic Petroleum Co.* v. *Commissioner*, 79 F. 2d 234, 236–237, 238 (C. C. A. 2d), certiorari denied, 296 U. S. 645, rehearing denied, 296 U. S. 664. See *Birmingham Ice & Cold Storage Co.* v. *Davis*, 112 F. 2d 453, 456 (C. C. A. 5th).

[4] Section 240 (d) of the Revenue Acts of 1921, c. 136, 42 Stat. 227; and 1924, c. 234, 43 Stat. 253; Section 240 (f) of the Revenue Act of 1926, c. 27, 44 Stat. 9.

an accurate distribution or apportionment of profits, income, and deductions, the decisions of the lower courts have established the governing principles as to the discretion and powers reposed in the Commissioner.[5]

The taxpayer claims that in applying the general provisions of Section 45 in the instant case the Commissioner has disregarded the specific provisions of Sections 23, 112 and 113 of the Revenue Act of 1936 (Appendix, *infra*, pp. 10, 11–12), which it is asserted, permit the subsidiary to deduct the loss in question. But as pointed out by the Circuit Court of Appeals (R. 68–70) and by the Board of Tax Appeals (R. 20a–21a), the Commissioner has not ignored but followed those specific provisions in determining the amount of the loss which, after determination, has been allocated to the parent company. Section 112 specifies the time when gain or loss is to be recognized for tax purposes and Section 113 provides the basis to be used in determining the amount of gain or loss. Assuming that Section 112 (b)(5) was applicable to the original transfer of the Standard Company shares from the parent corporation to its subsidiary, the Commissioner has used the proper cost basis of the parent in computing the amount of

[5] *Ellison* v. *Commissioner*, 76 F. 2d 509, 510 (C. C. A. 2d); *Nowland Realty Co.* v. *Commissioner*, 47 F. 2d 1018, 1021 (C. C. A. 7th); *Crossett Western Co.* v. *Commissioner*, 73 F. 2d 307, 308 (C. C. A. 3d).

the loss in accordance with the provisions of Section 113 (a) (8).

What the Commissioner has done is, first, to determine the amount of the loss under the applicable statute and, second, to allocate that loss between the subsidiary and the parent in order clearly to reflect the income of parent and subsidiary. Section 45 permits such an allocation in the sound discretion of the Commissioner.

Assuming there was originally a tax-free exchange, the subsidiary has not thereby acquired the undeniable right to take the loss deduction. Section 45 was designed to apply to any case where the transaction and the relationship of the parties is such that the loss properly should be accounted for by the parent rather than the subsidiary. Under the facts of this case it is only reasonable to treat the loss as one which has in fact been sustained by the parent, since allowing the loss to the subsidiary would plainly give an artificial picture of its true net income. That the parent will not receive a tax benefit from the allocation is immaterial. The power to allocate, granted by Section 45, is not dependent upon the allowance of a loss which reduces taxable income.

Moreover, apart from Section 45, the claimed deduction is probably not allowable. *Pennsylvania Indemnity Co.* v. *Commissioner,* 77 F. 2d 92 (C. C. A. 3d), so indicated upon similar facts, and this Court refused further review (296 U. S. 588).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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NOVEMBER 1943.